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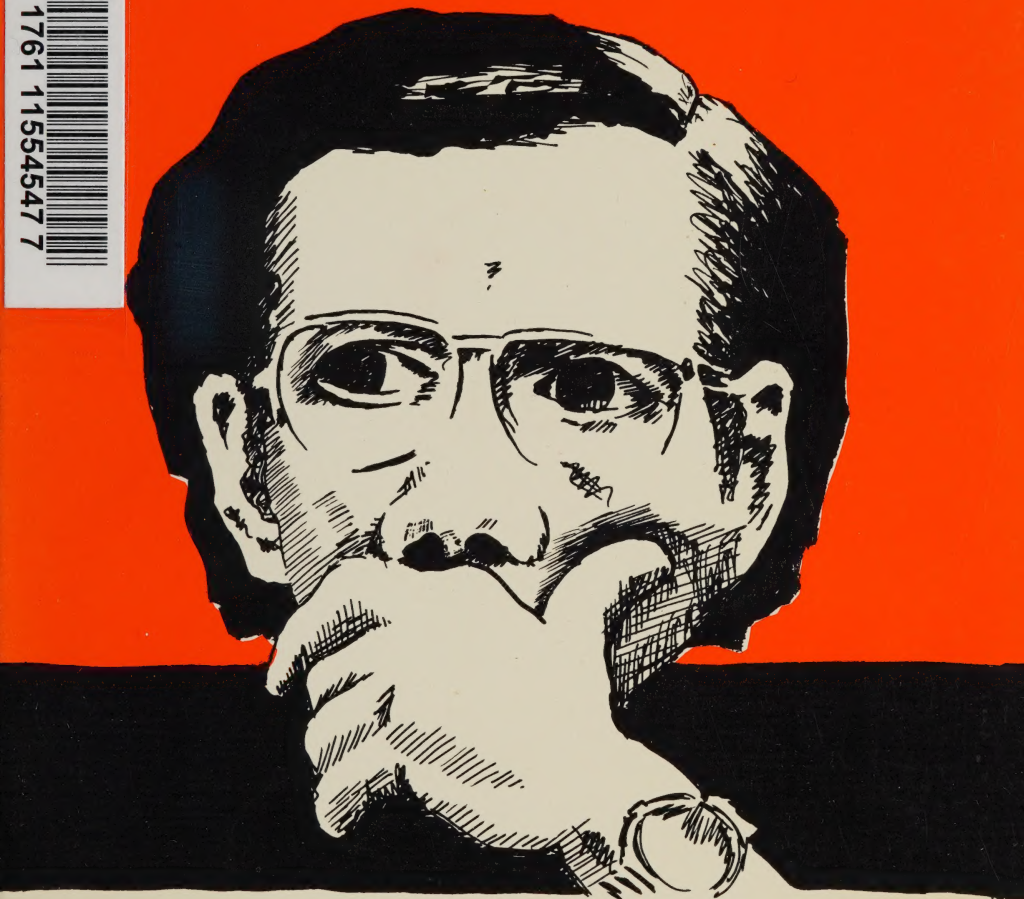

MINDING YOUR OWN BUSINESS

VOLUME 1

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ADVISORY
SERVICES

MINDING YOUR OWN BUSINESS

Volume I

Published by

INDUSTRIAL DEVELOPMENT BANK

Industrial Development Bank
901 Victoria Square
Montreal, Que.

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This material was originally published by Industrial Development Bank as a series of pamphlets entitled "Minding Your Own Business." (Pamphlet no's 2 to 10 inclusive). Original cross references in the text to pamphlet numbers have not been deleted.

FOREWORD

This book is written for people interested in small businesses. They may be teachers, bankers, accountants or students. Perhaps lawyers, government officials, industrial commissioners and business associations will find it useful. But it is written mainly for people who run their own businesses.

The majority of businesses in Canada are small. Partly because of their smallness, they sometimes have special management problems. The owner/manager is rarely a master of all management skills and yet is often directly responsible for the management of all aspects of his business. He has to be general manager, sales manager, personnel manager, production manager, controller, research manager and purchasing manager. It helps if he understands finance, banking, quality control, human relations, customer relations, government regulations and commercial law.

Since 1944, the Industrial Development Bank has been providing financial assistance to new or existing businesses in Canada, particularly those of smaller size. The Bank is also interested in helping to promote good management practices through its Advisory Services program. The publication of this book is part of that program.

E. R. Clark,
Chief General Manager,
Industrial Development Bank.

December, 1974

GIVING CREDIT TO YOUR CUSTOMERS

Credit has been defined as the ability to obtain goods or services in return for a promise to pay in future. More simply, it is a sale on trust. Why should you sell on trust? How do you know who to trust?

Every business has to face at some stage the fundamental question "Should we give credit to our customers?" The answer is not easy. For most businesses, the willingness to grant credit is important to their growth; to many it is essential to their well-being because their competitors offer credit terms. It is part of what they offer for sale.

The ready availability of credit is a major factor in our economic life. Credit buying has gained such widespread acceptance that its contribution to the economy and its significance to your business needs to be well understood. This pamphlet discusses some of the basic factors to be weighed in reaching a sound decision on granting credit.

THE ADVANTAGES

The advantages to both buyer and seller are real. The principal advantage of giving credit is that it increases sales by allowing goods or services to be purchased by customers who would otherwise be unable to do so, or who would purchase the same goods or services from others willing to offer credit. The customer, too, gets something out of it. It is convenient, and exchanges and returns are easier. He may be able to buy a little extra and increase his own sales. He will be a happy customer who will come back for more.

........AND THE DISADVANTAGES

The principal disadvantage for the seller is cost. When selling on credit a business is giving away its product, temporarily. Payment will not be received immediately but nevertheless the costs of pro-

ducing the product must be paid by the seller. The effect is the same as making the customer a loan. Greater amounts of capital must be available than would be required by a business operating solely on a cash basis and the cost of this capital is an added expense to the seller.

The costs of determining which customers are worthy of credit, as well as the costs of maintaining records of amounts owing, of billing and of collecting, are costs not faced by the cash business. Also, no matter how careful you are in granting credit, there will likely be some customers who won't pay, and the resulting bad debt expense is a very visible one. A less obvious drawback is that a customer is more likely to return or exchange goods for which he has not paid, with resulting inconvenience to the seller. The availability of credit may promote extravagance on the part of the buyer, or may even inadvertently encourage the seller to oversell his customer, leading him to purchase goods which he does not need and cannot afford. The seller ends up paying for such goods.

YOU MAKE THE RULES

Assuming you have weighed these points and have decided to offer credit to your customers, where do you start? By establishing the rules by which you will grant credit. Decide what terms will be offered and what limits will apply. Decide what discounts will be allowed for prompt payment. Remember that discount terms are sometimes misleading. For example, suppose you decide to offer terms of one percent, ten days, net thirty days. That is, if your customer pays within ten days, you give him a one percent discount, but if he pays during the twenty days remaining till the due date, he has to pay the full amount. This means you are charging him one percent more for a period of twenty days, if he takes thirty days credit, instead of ten days. At a glance you may not feel this in an attractive discount to offer but it amounts to $\frac{365}{20} \times 1 = 18\frac{1}{4}$ percent per year.

Decide what action will be taken when accounts become overdue and what interest rate will be charged to them. Each of these decisions should be reached prudently for the future of the business is at stake.

WHO CAN YOU TRUST?

Having established a credit policy, it is time to apply it. Evaluate each customer, whether you sell to firms or individuals. There is a sound, systematic way of doing this and the three basic characteristics most often looked for are the "three C's" of credit — character, capacity and capital. All three are essential and closely linked, but it is the character element which warrants closest scrutiny. Without it, capacity and capital have little meaning. On the other hand, shortcomings in capital and capacity can often be overlooked in the presence of credit character — the intention and, most important, the willingness to pay.

Start with a well-designed questionnaire form for credit applicants. Elementary details to be recorded on it include the customer's name, address and occupation, of course. Length of time at present address and frequency of moving. Amounts and sources of income. Financial obligations. Bank account. Credit cards.

Once a credit application is received, it's common practice to ask more questions — of the applicant's bank, trade organizations, his other suppliers and credit bureaus such as Retail Credit Company and Dun and Bradstreet. How much does he owe and to whom? Does he have a good payment record? Has he shown stability in his business background? Why does he need credit? If it is solely because he is short of cash, but otherwise meets the criteria which have been established, he may be an excellent risk. But if it is because he is short of cash and overextended elsewhere, he may be a poor risk. Good judgment in analyzing credit risks is vital for successful credit management. If you decline good risks, or accept poor ones, your business will suffer.

PUTTING IT TO THE TEST

Having decided to whom to give credit, the terms under which it will be offered should be set out and explained very clearly to each customer. In most cases a credit limit should be specified so the credit will not extend beyond the customer's ability to pay. A cash downpayment on certain types of purchases is a useful deterrent to unnecessary or excessive purchases. The payment terms should be

established carefully, in keeping with the nature of the purchases and the needs of the buyer. For example, don't allow several months to pay for perishable foods. In some cases, credit should be made available only until the customer's next pay day.

GETTING YOUR MONEY BACK

The best laid credit plan will fail unless an effective invoicing system is established and used. Forget to send your bills and some of your customers will probably forget to send their payments. A prompt reminder to a delinquent account will usually bring results, serving to reaffirm the rules under which credit was offered. If this doesn't work, a re-discussion of the terms of the credit should be conducted to determine the reasons for a customer's failure to meet his commitments. But use common sense and tact. Perhaps he isn't paying because of a temporary setback which might be alleviated by amending the credit terms. But if he has lost his willingness and desire to pay, further credit privileges should be withdrawn. Interest should be charged on the overdue account, or, if already being charged, the rate of interest should be increased. Such penalties will frequently have a chastening effect but, if they fail, act decisively through repossession of goods or other legal means.

Just as a credit granting policy is important, so is a credit collection policy, applied consistently and fairly, because it is the paid-up customer who can buy more and because prompt payment eliminates expenses caused by slow payment. Failure to take action, mildly at first but with increasing severity, on an overdue account can only encourage the delinquent customer to pay even less attention to his obligations. Care should be taken, though, when approaching the period for final action, to differentiate between customers able but unwilling to pay and those willing buy unable to pay, or unable to pay within a reasonable time. In the latter case, patience may be less costly than legal action.

TAILOR YOUR OWN CREDIT SYSTEM

No attempt has been made in this pamphlet to describe the mechanics of setting up and operating a credit granting system. This

will depend on the size and type of your business. The details of procedures, equipment and forms can best be designed and implemented by a qualified consultant, most often the firm's auditor or accountant.

Few factors in modern business contribute more to its growth than the sound use of credit. Giving it means taking some risks, but they can be kept to a minimum by consistently following sound credit policy and procedures. Giving credit to your customers will usually reflect credit on your business.

PRESENTING YOUR CASE FOR A TERM LOAN

Regardless of where you seek term financing for your business, the information required by each lender will be basically the same. The lender will want to know

- WHO YOU ARE
- HOW YOUR BUSINESS IS DOING
  (Unless you don't have one yet)
- WHAT YOU PLAN TO DO
- WHAT YOUR PLAN WILL DO FOR YOUR BUSINESS

Naturally, the lender will also want to see how he might fit into your plan for the several years that you would use his money. The same things you would want to know if you were asked to lend your money for several years. For a small business, the preparation of this information, and the analysis that backs it up, can be quite simple. The basic points stated above lead to the main lending criteria used by term lenders in considering a proposal.

WHO YOU ARE

One criterion of great importance is the quality of management of your business. WHO YOU ARE gives the term lender a glimpse of what to expect from the management of your business. Your education, your experience (or lack of it), your accomplishments, your shortcomings and who on your management team makes up for them, are all of interest. Jot them down. Term lenders can also compare, from their own experience, the relative strengths of your management with many other businesses, particularly those in your industry. Obviously your diligence and determination to make a success will be major factors, too. No management group in a small business is likely to look perfect to an outsider. Discussion of

it with a term lender may sometimes lead you to make improvements that may eliminate possible future problems in management.

HOW YOUR BUSINESS IS DOING

Of greatest single importance to most lenders, and naturally to you, is the ability of your business to earn sufficient profits to repay the term loan, with enough left over to meet the normal needs of the business. Without this ability your business will fail. HOW YOUR BUSINESS IS DOING will tell part of this story.

So present your balance sheets and profit and loss statements for the past four or five years, if you've been in business that long. If you are starting a new business, show your balance sheet as it would look when you start, having obtained the financing required.

WHAT YOU PLAN TO DO

A concise way to show someone else, such as a term lender, WHAT YOU PLAN TO DO is to make a tabulation of your plan and its financing, for example:

PROGRAMME		FINANCING	
Purchase land	$ 3,000	I.D.B. loan	$48,000
Construct building addition	50,000	Additional share-	
Purchase & install equipment	7,000	holders' investment	17,000
Provision for contingencies	5,000		
	$65,000		$65,000

This presentation can then be expanded on by footnotes or attached sheets, giving the details of each item, e.g. the size, location and legal description of the land, the plans for the building addition, and so on.

You should indicate clearly which items of the cost are firm, and which are based on estimates only. In the example above a provision for contingencies of $5,000 is included to allow for such things as inaccuracies in estimating, items overlooked and changes during construction involving extra cost. The amount that you should provide for contingencies depends on the nature of your programme and the portion which is subject to estimates only. Even for the portion which is firm, there will often be changes made while the programme is in progress, particularly where it involves the installation of machinery and equipment. These changes often add to the cost of the programme. In some cases, a contingency reserve of at least 50 per cent is desirable even when a large part of the programme is covered by firm commitments. In the average case, a cost overrun of 10 per cent to 20 per cent can be expected. A corresponding provision for contingencies at the outset will prevent a shortage of funds when your programme is only partially comppleted.

It is also important to demonstrate that your programme will bring tangible benefits to your business. In the case of a large sophisticated business, with careful control over capital budgeting, it is normal for a lender to require that an analysis be made of what is expected from a particular project by way of decreased costs and increased net revenues. For a small business, without the same degree of sophistication in capital budgeting, such an analysis is difficult to prepare. In any case, there should be some thought given to the potential savings to be derived from the programme. If the main purpose of the programme is physical expansion to take care of increasing sales volume, you must ensure that the expansion is in reasonable relation to the expected sales volume, as there are few businesses that can really afford to have a large amount of unused or excess capacity.

Finally, of course, would come details of the sources of financing proposed for the programme. Sometimes this would simply be the term loan itself but, in other cases, the programme might involve fresh investment by you, or perhaps the use of working capital. In the case of fresh investment, a lender will normally want you to satisfy him that the money for it is available. If part of the financing is to come from working capital, it is helpful to have ready some analysis of how this could be accomplished without jeopardizing

the working capital required for the normal day-to-day financing of the business.

WHAT YOUR PLAN WILL DO FOR YOUR BUSINESS

Your past financial statements only give an indication of what to expect from your business. WHAT YOUR PLAN WILL DO FOR YOUR BUSINESS is the more important part of the picture. What will your financial statements look like in the future? It is fairly easy to show what your balance sheet will look like right after your plan is completed. You will have more assets, purchased with the new financing. You will also have more liabilities, including the term loan, and perhaps there will be new investment by you and others. The term lender can help you make up this picture.

He will probably refer to it as a ''pro-forma'' balance sheet. But the main point is that it shows the immediate effect of your plan on your balance sheet. It might point out a strong point in your plan that you hadn't thought of. For example, it might show that the amount of new debt would not upset the balance of total debt to owners' investment that a successful business should maintain. It might show the reverse. The term lender can advise you on that, too.

But you still haven't shown what your business will earn in the years following completion of your plan. You have shown a bit of the future in the pro-forma balance sheet, but now you have to look further ahead to see what your profit and loss statements will look like after your plan is completed. You are best equipped to do this, as no one else knows the details of your business like you do.

Visualize what your plan will do to each item on your profit and loss statements during the remainder of your fiscal year after the plan is completed. And don't forget new items of expense that may not exist now. First, estimate your new sales volume, realistically. Base this on a good knowledge of your market, not on hope. Then estimate your new labour and material costs, plant overhead, sales expenses, and administration and financial expenses. It is surprising how many of these would be affected, when you think about each of them. And they all affect your resulting profit.

To satisfy yourself further, do this for the next full fiscal year and the one after to demonstrate that a good level of profit will continue. If your plan is modest, requiring, say, a $10,000 term loan, this "earnings forecast" will be quite simple to calculate. If you need a term loan of several hundred thousand dollars, on the other hand, many items on your profit and loss statements would likely change considerably in the future. In this case you would be wise to show these changes for several more years into the future.

Briefly then, the balance sheets and profit and loss statements of your business, for the past and for the future, are the main financial tools you should present.

SECURITY

Since most term loans are secured by the term lender taking a charge on the fixed assets of the business, it is apparent that the security value of these assets is also a criterion affecting the amount of term financing you might obtain. If the fixed assets of your business comprise only leasehold improvements, which usually have a very low relative recovery value in the event of liquidation, it is obvious that security values would be very low. On the other hand, a mortgage on a well-located, general purpose building of good quality construction, represents very good security. However, many lenders are prepared to make a loan which is under-secured by the fixed assets if the business has excellent earning prospects. Be prepared to describe your land, buildings, machinery and equipment.

FINANCIAL STRENGTH

Finally, there is the general financial strength of the business, now, and after your plan is completed. Will there be sufficient capital to meet trade debts promptly, to survive seasonal lulls comfortably and to maintain good deliveries and service to your customers? Again your balance sheets and profit and loss statements will enable the term lender to make a few simple tests to satisfy him about your financial strength.

WORKING CAPITAL

The working capital of your business, expressed in accounting terms, is the excess of its "current" assets over its "current" liabilities. It should be sufficient to provide for the payment of current liabilities as they come due and for the financing of day-to-day operations.

There is no precise guide for the working capital needs of a small business, but the expected working capital position, after completion of your programme, should be looked at carefully to ensure its adequacy. Working capital needs vary from one industry to another. It is, for example, normal in the printing trade to have extended terms of as much as a few months available from suppliers, whereas a meat packer could expect at best ten-day terms from his suppliers. Some businesses sell on a cash basis and pay for their supplies on terms, so that they can conveniently operate with a working capital deficit.

The term lender can assist you to determine what amount of working capital your business should need after your programme is completed. This can be compared with the amount it will likely have by that time, giving effect to any new funds from shareholders' investment and additional profits during this period, offset by payments for the new debt and possibly for liens, profits taxes and the like.

PRODUCTS AND MARKETS

If the goal of your programme is to expand productive capacity, a lender will naturally be concerned with the market potential for the present or proposed products of your business. This coul involve some assessment of the competitive position of your business in its industry, or of the industry itself in relation to alternative products or services. This requires a look at such factors as prices, obsolescence, style, quality and design. Even though your business has been successful in the past with its products and services, this is not necessarily an assurance that it will continue to be successful. In essence, the lender tries to determine how solidly your business is established

in its market, and the reasons for the unique success which it has or will enjoy.

Having obtained a good idea of products and markets, it is desirable to relate your physical expansion project to your existing plant facilities to ensure that there will be no unforeseen bottlenecks, and that capacity of the enlarged plant will be reasonably well matched to the production and sales needs.

THE NEW BUSINESS

In the case of a brand new business, the analysis will follow along similar lines to those outlined. It is apparent though, that the projections, particularly the earnings projection, are most important as there are not past results to go by. Also several new factors will be introduced. In analyzing the project, it will be necessary to make provision for the inevitable "pre-production" expenses. Further, the average new business will probably suffer a period of cash losses as volume is building up, and there should be some money to take care of these.

A shortage of working capital is one of the most important features leading to bankruptcy of a new business. If a business gets into trouble, it is difficult to obtain additional working capital assistance. It is far better to provide for a comfortable amount of working capital at the outset. The new businessman should not skimp on this.

Another indicator which is often useful in looking at a new business is a "break-even" analysis. The break-even point of your business is that yearly volume of sales at which your business starts to make a profit. If your sales fall below this amount, your business will show a loss. Hopefully, you will be able to maintain sales well above the break-even point and generate a reasonable profit. This analysis gives you some insight into the percentage of the market you have to capture. You can then gain a better understanding of the probable risks to be faced by your new business when entering the market. As the percentage of required market capture increases, the risk of failure to meet the requirement increases. In some cases such an analysis might indicate that a more modest initial programme would be desirable, or that a very much larger amount of money should be provided as a cushion to meet unexpected, but

perhaps inevitable, difficulties in trying to obtain a large percentage of the market. Of course, some new businesses have natural advantages of distance from competitors in serving local market needs, or an ability to provide much better service. Such factors protect them from competitive retaliation by those already in the market place.

CONCLUSION

This outline of the information to present to a term lender is rather imposing, but you can call on your accountant and the term lender to help you prepare it. Naturally, if the risk is small in amount the analysis need be in far less depth than for a large loan. The depth of the analysis would also depend on the complexity of your business organization, the risk inherent in the particular industry and many other features. However, the lender cannot make a valid decision on a term loan without considering all these features to some degree. Furthermore, if you have a small to medium-size business, where management control is effectively in your hands, or those of a very small number of individuals, this review of your expansion project with a lender can be valuable to you. It can reduce the risk of some significant error or oversight in your plan and strengthen your chances for success.

FORECASTING FOR AN EXISTING BUSINESS

If you are considering expanding an existing business, one of the first questions you might ask yourself is: What kind of an operating statement can I expect to see after a year's operations? It is certainly one of the first questions a lender will ask if you need a loan to expand. An operating forecast can also be very useful to a business which really has no thought of expanding in the near future.

WHAT IS IT?

For an existing business, the preparation of an operating forecast gives the owner the opportunity to set down what he expects will happen to his revenues and costs. Generally, an operating forecast is prepared for a one-year period — the year following the year-end of the business' financial statements. This does not mean that operating forecasts should be prepared for only one-year periods. Many businesses find it very useful to prepare a one-year operating forecast and then break it down into shorter periods — say 6 or 3 months, or, to help in longer term planning, preparing forecasts for 4 or 5 years ahead.

WHY DO IT?

Preparing an operating forecast need not be too time-consuming and it does have a number of benefits:

(a) Because an operating forecast for an existing business is based on past experience of the business, it gives you an opportunity to learn more about your business;

(b) Because it gives you an opportunity to study the business' past results in detail, it may disclose opportunities to expand the business which might not be apparent during the

hectic day-to-day operations of the business. It may help in planning a smooth expansion of the business. *For example:* Let's suppose that a motel operator is studying the business' previous operating history. He might find that revenues from his small restaurant had been increasing quite substantially, even though there had not been any noticeable increase in the occupancy rate of the motel itself. The occupancy rate might be his major concern in the normal course of business. He might, therefore, not normally pay too much attention to the restaurant revenues, which might make up only a small portion of total revenues of the business. The increase in restaurant revenues, if extended into the next year and subsequent years, might well cause him to examine the restaurant situation very closely. He might then want to consider expanding the restaurant, both to be sure that motel customers could be fairly certain of getting a meal when they wished to and to take advantage of the response the restaurant received from the general public.

(c) Again because it required study of past experience, preparation of an operating forecast can help in drawing the business operator's attention to expenses which should be watched closely.

(d) Preparing an operating forecast to provide for increased or new expenses and revenues which the owner expects to result from a change in the business' operations will help him in making a decision on the various alternatives that might be available to him. For example, to buy or lease certain assets; to put up a new building or renovate the old one; to change the variety of products sold or produced and other decisions which will affect the future of the business.

(e) Comparison of a forecast and the results actually experienced may also help in pointing out areas of opportunity or concern. The information about the business' operations that could be obtained from preparing an operating forecast may not, of course, necessarily come *only* from preparing an operating forecast. However, by encouraging

the owner to look ahead, preparation of an operating forecast may help in spotting areas of interest and concern *before* they become urgent. You might find that in spite of increasing revenues, profits have been actually declining slightly. If this decline in profits continues, the business might be hard put to meet its requirements for purchase or replacement of equipment or to provide for its other requirements. This would likely then cause you to look at expenses to see which of these had shown a tendency to increase and by how much they had increased. You might then be able to look at certain specific expenses to see where the problem lies and what can be done about it to put profits back where you want to see them — *GROWING*.

WHAT YOU EXPECT; NOT WHAT YOU HOPE

Before starting an operating forecast, you should decide to prepare it on the basis of what the business has done and what your business can *reasonably* be expected to do, rather than what you hope it will do. Naturally, every businessman hopes that his revenues will grow by "leaps and bounds" and that profits will double or triple over what he has experienced. This is seldom the case. The operating forecast can bring our hopes for the business "back to earth". This can be done by tying the next year's revenues and expenses into what has gone on in the past, and making reasonable allowances for the revenues and costs that can be expected to occur if past experience holds true. If past experience is not expected to hold true, then there should be a reasonable basis in fact as to why this will not be the case.

HOW TO PREPARE THE FORECAST

In order to prepare an operating forecast, you will need to determine all the changes that you can expect to occur in your business' operating statement. If you are considering a change in the operations of your business, the effect this change may have on the revenues, expenses, and profits of the business can, perhaps, be

more readily appreciated if you take the time and effort necessary to prepare a detailed operating projection. Generally, an operating forecast would be based on the most recent operating statement for your business. The forecast would show the changes you expect to occur in revenues and expenses in the following year. Revenues and some expenses might increase or decrease; new expenses might be incurred and other expenses might disappear. An example may be helpful.

Assume that your business operates from leased premises (with, say, a lease involving payments of $300/month with the landlord paying utilities and realty taxes — but not business taxes). You might be thinking of buying or constructing a building of your own. For example, the location of the leased building might not be the best possible for your business if it relies to a great extent on passers-by as its customers.

In preparing your forecast, you might first attempt to determine whether you could expect the business revenues to increase, by additional space permitting you to carry additional lines. Alternatively, the move to a new location would mean that more customers would be coming into the store. Sales would then increase. Having determined this, you would then have a reasonable idea of what the business' *revenues* for the next year might be.

It would then be necessary to determine the cost of the goods which you expect to sell during the next year. If the cost of the goods sold has been reasonably consistent in relation to revenues over the past years, the cost of the goods sold could simply be calculated as follows:

1. Assume revenues are expected to amount to $200,000.
2. Assume that cost of goods sold has in each of the past 6 years amounted to 80 per cent of revenues.
3. We can then forecast that the cost of goods sold in the next year would be $160,000 (80 per cent of $200,000 = $160,000). "Cost of goods sold" would in most small businesses include all those costs of the goods purchased for resale by the business and would include the amount the business has to pay suppliers, freight and delivery expenses to the store, etc.

You would then have to determine what changes might occur in other costs of operating the business if a building were to be purchased.

1. You might find that because of the larger store and additional product lines, another clerk would have to be hired.
2. Since you would acquire a depreciable asset, depreciation expense would increase.
3. The business would have to pay utilities and realty taxes which it does not now have to pay according to its lease arrangements.
4. Delivery costs, that is, the cost of delivering goods *from* the store *to* customers would likely increase as revenues increase.
5. Insurance costs would increase since you would have to insure the building and the increased inventory which you may now be able to stock.
6. If you have to borrow money to buy or construct the building, interest costs would increase.
7. The business would no longer have to pay rent.
8. If the business gives credit, increased volume may mean increased accounts receivable which may in turn mean increased bad debt losses.

Attached are a hypothetical operating statement for this business for the year ended December 31, 1971 (Appendix A) and an operating forecast showing what the owner expects to see in his operating statement for the year ended December 31, 1972 (Appendix B).

With this kind of basic analysis, the operating forecast becomes one of the most useful tools the businessman has in planning the future course of his business and determining which, of many possible alternatives, he should choose.

OPERATING STATEMENT FOR THE YEAR ENDING DECEMBER 31, 1971.

Revenues		$150,000
Expenses		
Cost of goods sold	120,000	
Wages — to part-time clerks	7,000	
Overhead — included in rental payment of $300/month	nil	
Depreciation — on fixtures and equipment	500	
Delivery expenses — delivery from store to customers	2,000	
Telephone	200	
Interest	200	
Insurance — on inventories, equipment, etc.	175	
Advertising	1,500	
Delivery vehicle repairs	150	
Bad debt expenses	200	
Rent — $300/month	3,600	
Business taxes	200	
Realty taxes — included in rental payments of $300/month	nil	
	135,725	
Plus: Cash withdrawn from the business by the owners	7,000	
Total expenses and owners' withdrawals		142,725
Net Profit		$ 7,275

FORECAST OPERATING STATEMENT FOR THE YEAR ENDING DECEMBER 31, 1972.

Assuming: Land and building are purchased for $20,000 and a term loan of $20,000 is arranged at an interest rate of 9 per cent.

Revenues		$200,000
Expenses		
Cost of goods sold — 80 per cent of revenues	$160,000	
Wages to part-time clerks (assume you find that because of the lay-out of the new building, no additional clerks will be required).	7,000	
Overhead — which the business will now have to pay	800	
Depreciation — on fixtures & equipment	500	
Depreciation — on the building (assume the land, which is not depreciable, cost $5,000, and the building cost $15,000)	750	
Delivery expenses — expected to increase as a result of increased sales	2,500	
Rent — will no longer be paid	nil	
Telephone expense	200	
Interest expense — increased because of interest on term loan	2,000	
Advertising expense	1,500	
Delivery vehicle repairs (increased because vehicles are becoming older)	250	
Insurance — increased because building and larger inventories must now be insured	300	
Bad debt expenses — increased because of increased credit being given	300	
Business taxes	200	
Realty taxes — which the business will now have to pay since it will own the property	800	
	177,100	
Plus: Cash withdrawn from the business by the owners	8,000	
Total expenses and owners' withdrawals		185,100
Net Profit		$ 14,900

MANAGING YOUR CURRENT ASSETS

If you manage your own business, or are thinking about doing so, it is important to know how to handle current assets. The left side of your balance sheet shows the assets of the business, that is, the things your business owns, such as inventories, and things owed to it by others, such as accounts receivable. They are divided into categories, the main ones being current assets and fixed assets. How much of your investment should be in current assets? In a small business this means simply how much cash, accounts receivable and inventories does your business need — to start with, during your busy and quiet seasons, and when you are expanding.

Current assets are cash and things that can be converted to cash in the near future, usually within twelve months. They are listed on your balance sheet in the order of how close they are to cash, starting with cash itself, as in the following example:

SMALL ENTERPRISES LTD.
BALANCE SHEET — DECEMBER 31, 1971

ASSETS		LIABILITIES	
Cash on hand	$ 200	Bank loan	$4,000
Cash in bank	2,000	Accounts payable	2,000
Canada Savings Bonds	1,000		
Accounts receivable	5,500		
Inventories	7,000		
Total Current Assets	$15,700	Total Current Liabilities	$6,000

Let us suppose that this business is selling about $5,000 of goods or services per month during the winter. Is it managing its current assets effectively?

CASH

Most small businesses need a petty cash fund to take care of minor items that arise on a day-to-day basis. So there is no real

quarrel with the $200 "cash on hand". The amount should be kept as small as possible, though, so a minimum of money is sitting idle, not generating a return on the investment.

The $2,000 "cash in bank" looks unnecessary for normal operation of the business. The company is receiving bank credit, and unless this relatively large deposit was needed for a special purpose at the balance sheet date, it seems unjustified. Similarly the investment in Canada Savings Bonds might better be employed in financing the operation of the business.

ACCOUNTS RECEIVABLE

I.D.B. Pamphlet No. 2 "Giving Credit to Your Customers" outlines briefly some of the principles of a credit system for a small business. The amount of your accounts receivable, the amount owed to your business by customers for goods or services you sold them on credit, will depend to a large extent on the rules you have set up for granting credit to your customers and the way you apply them. If your credit terms are vague and your invoicing system sluggish, your accounts receivable will tie up too much of your investment. This costs your business money.

There are a couple of simple ways of keeping an eye on your accounts receivable. One is to "age" them, that is to classify them according to their age since the date of sale. In the case of Small Enterprises Ltd., an ageing of the $5,500 accounts receivable at December 31st, 1971 shows the following:

	$	%
Receivables outstanding less than 30 days	$4,400	80
Receivables outstanding 30 to 60 days	770	14
Receivables outstanding over 60 days	330	6
	$5,500	100%

If the selling terms of this business are net 30 days, 20 per cent of its receivables are overdue. If these overdue accounts didn't exist, the $1,100 tied up in them could be put to use in producing more goods or services for sale.

The ageing analysis, made up from a listing of all your individual accounts receivable, can be done quite quickly on a regular basis, for example at the end of each week or month. If you know your customers, you will also know from the ageing analysis what "quality" the overdue accounts have, that is, what likelihood there is of collecting each, or whether a bad debt loss might be expected from some.

You can also see from examining the accounts receivable whether any overdue amounts comprise mainly one or two large accounts. Just ask your bookkeeper to list separately the accounts overdue in amounts of more than, say, $100 or an appropriate amount that is "large" for your business. In the above example, it might be that the $330 outstanding over 60 days is all due from one customer. If steps to collect from this one customer were applied successfully, the accounts receivable picture would improve sharply.

You can also follow, from the ageing schedules for several consecutive periods, whether your collections are improving or whether old accounts are piling up. This might suggest a need for changing your credit terms and collection practices.

If your credit and collection system is under control, the level of your accounts receivable will likely vary directly with sales volume. Another simple test is to calculate the average collection period. If Small Enterprises Ltd. had sales of $75,000 in 1971, the accounts receivable of $5,500 at the end of that year represent about 27 days sales $\frac{(\$5{,}500}{(\$75{,}000)} \times 365$ days). The average collection period is therefore 27 days. It would be even more accurate to calculate the average collection period by using the average of the accounts receivable at the beginning and at the end of the year. Also, the calculation could be based on business days in the year, rather than calendar days. This involves a bit more work and the main point is to do it the same way each time.

The average collection period can also be calculated on a monthly basis, each month-end. If December 1971 was a slow month for Small Enterprises Ltd., with sales of only $5,000, the

accounts receivable of \$5,500 at the month-end were 33 days sales $\frac{(\$5{,}500}{(\$5{,}000} \times$ 30). This is higher than the year's average collection period of 27 days' sales, and might be an indication of a slow-down in collections. If so, steps should be taken to urge more prompt payment by customers. On the other hand, it could be that the business normally gives more credit in December than at other times of the year. The circumstances will indicate what collection steps, if any, are required and care should be taken to achieve the best results with a minimum of offence to customers.

INVENTORIES

To control your investment in inventories you need to know regularly what quantities of materials, supplies and finished goods your business requires in stock and what value to give to them. The inventory of a manufacturing business will normally include raw materials, goods in process, finished goods, parts, and supplies, such as the packaging materials for the finished products. In non-manufacturing businesses the inventory may consist of supplies or finished goods, or both.

Consider first the size of inventory required. It is common practice in many businesses to take a physical count of the entire inventory at the end of each business month. This tells you how much inventory you actually have. But how much should you have for good control of your investment?

Generally speaking the smaller the inventory you can carry, and still not run into shortages and slow deliveries to customers, the better. So you should know how fast your finished goods inventory moves out of your business to your customers, that is, how fast it "turns over". Unfortunately, most businesses cannot stock their products just to meet firm orders. They have to have additional goods on hand at all times. Your customers expect you to supply exactly what they want when they need it, or they will buy elsewhere. A complete inventory is needed, including fast-moving and some slow-moving items, but your business should not be overburdened with the latter. If you know where you can get some of these items quickly, perhaps in one day's delivery, you

may not need to stock them. You should also know what minimum and maximum inventories you need for your slow and busy sales seasons.

Small Enterprises Ltd. is a manufacturer, and $2,800 of its year-end inventory of $7,000 was raw materials. This amounted to about 17 days' sales, with December sales of $5,000. January sales were expected to be the same. The company had found from experience that "17 days' sales" was an adequate inventory of raw materials to keep its production running on schedule. Alternatively, the company could compare its inventory with its purchases rather than sales, and express the inventory as so many days' purchases. It forecast its sales and corresponding material purchases for each month of the coming year and bought its raw materials in advance accordingly. For a month in which $8,000 sales were forecast it would increase its raw materials level to about $4,500, 17 days' sales. This requires a close watch on purchasing, familiarity with delivery times, price changes and discounts available.

Small Enterprises Ltd. had a goods-in-process inventory valued at $200 at December 31st, 1971. This was the value of the partly-finished products in the plant at the end of that day. In some circumstances this can be reduced by speeding up the plant either mechanically or by using more labour, or by improving the scheduling of production.

This company had finished goods worth $4,000 at December 31st. There were ten different products and each item was recorded on a card showing the quantity on hand, its value and the "re-order point". When the quantity was reduced to this re-order amount, the company would produce or re-order that product. Inventory control systems are described in many readily-available publications, including "Controlling Inventory in Small Wholesale Firms", listed in I.D.B. Pamphlet No. 1.

In many businesses such as this one, a small percentage of the inventory items account for a large percentage of sales. Small Enterprises Ltd. found its breakdown to be:

Products	% of Inventory	% of Sales
1 and 2	20	75
3, 4 and 5	30	15
6 to 10 inclusive	50	10

Obviously, products 1 and 2, the fast movers, should receive close attention in the inventory as they account for 75 per cent of the company's sales. The finished goods inventory can be reduced if more firm orders are obtained, and production is scheduled for their immediate delivery.

For an overall rough check on the size of your inventory another simple calculation, done regularly, is quite useful. Compare your total inventory, all categories, with your average monthly sales for the past several months, say six months. Small Enterprises Ltd. had the following sales for the last half of 1971:

July	$ 8,000
August	8,000
September	7,000
October	6,000
November	5,000
December	5,000
6 Months Total Sales	$39,000
Average Monthly Sales	$ 6,500

The total inventory of $7,000 at December 31st was therefore about 32 days average sales. The company had found that a total inventory of about 30 days average sales was sufficient for normal operations and had gradually reduced it for the fall and winter, its slack season. It would continue to reduce it to about $6,500.

So much for the quantities of inventory required by a business. How do you price the quantities? A simple method is to price each item at cost or market value, whichever is lower. This avoids overstating the value of your inventory in the event of a decline in the selling price of certain items.

In pricing the finished goods inventory in some businesses, certain items may also lose all or part of their value because of spoilage, a sharp change in fashions, or other factors.

EXPANDING YOUR BUSINESS

If the sales of your business are increasing sharply, or if you plan an expansion to increase your sales, you should also plan

what current assets your business will have at the new sales volume. Generally speaking, your accounts receivable and inventories will increase, but normally you would not need more cash on hand or on deposit.

Small Enterprises Ltd. had sales of $75,000 in 1971, 20 per cent more than its volume of $62,500 the year before. It had studied its orders and markets carefully and forecast sales of $90,000 in 1972, another 20 per cent increase. This would be more than the plant could produce unless it added another machine early in 1972. The company decided to buy the machine and it would be in production in March. What investment would it need in current assets at this higher level of sales?

"Cash on hand" of $200 could be maintained but the $2,000 "cash in bank" and $1,000 Canada Savings Bonds could be spent on new materials and supplies. Accounts receivable would be expected to increase to $6,650, still averaging 27 days' sales at the new sales volume, i.e., ($\frac{27}{365} \times \$90{,}000$).

Based on the past, the average raw material inventory should be increased to about $4,200, or 17 days' sales ($\frac{17}{365} \times \$90{,}000$). Its goods-in-process would likely increase due to the additional machine to perhaps $240. Similarly, 20 per cent more finished goods, i.e., $4,800 on the average, might be needed to fill the additional orders, although this would depend on the new higher production rate and the proportions of items being sold. This would mean a total inventory of $9,240, rather than the former level of $7,000.

In summary, the old and new levels of inventory would be as follows:

	1971 Sales $75,000	1972 Sales $90,000
Raw materials	$ 2,800	$ 4,200
Goods in process	200	240
Finished goods	4,000	4,800
Total Inventory	$ 7,000	$ 9,240

The current part of the company's balance sheet might look like this during the next peak sales period, say June 30, 1972.

SMALL ENTERPRISES LTD.
BALANCE SHEET — JUNE 30, 1972

ASSETS		LIABILITIES	
Cash on hand	$ 200	Bank Loan	$3,000
Accounts receivable	6,650	Accounts payable	2,400
Inventories	9,240		
Total Current Assets	$16,090	Total Current Liabilities	$5,400

CONCLUSION

A few simple checks — ageing of receivables, calculating the collection period, and analysing the inventory by size and products — can guide you in managing your current assets. If done regularly, they can help you to keep your investment in current assets down to a level your business can afford. This means your money is being used where it is most needed and some will be available for the other main category of assets, fixed assets.

FORECASTING FOR A NEW BUSINESS

WHY FORECAST?

As mentioned in I.D.B. Pamphlet No. 4 "Forecasting for an Existing Business", careful preparation of an operating forecast is one of the most useful and meaningful tools available to a businessman. It can help you to spot opportunities, and to learn more about your business. It might also point out things about your business which could cause financial difficulty if left untended for a lengthy period. The results (revenues, profits, etc.) of the *business' operations* as shown by the operating statement, will have direct bearing on the business' balance sheet and, of course, on its future.

An operating forecast can be described as the operating statement which a businessman would expect to see for his business at the end of the period for which the forecast is being prepared. Generally, this period would be a year. For a new business, the forecast would show what revenues and expenses you expect the business to experience in its first year of operation. It can be very useful, of course, to prepare a forecast for a longer period than one year. But preparation of the first year's operating forecast is one of the first steps taken in planning the establishment of a new business.

THE EXISTING BUSINESS AND THE NEW BUSINESS

If the operations of an existing business undergo a slight change, there is generally enough similarity before and after the change to make past experience meaningful for the future. In some ways, then, preparing an operating forecast for an existing business may be less challenging than preparing one for a new business.

In the case of a new business, there is no historical record to go by. For this reason, preparation of an operating forecast for

a new business can be an interesting and rewarding experience, even though time and effort will be required.

GUIDELINES AND THE FORECAST

You can sometimes obtain guidelines on revenues and costs for a particular type of business from magazines and periodicals (for example, the publication "How to Start and Manage a Small Restaurant" listed in I.D.B. Pamphlet No. 1) or firms engaged in the type of business you are considering. By reading a lot and talking to many people you could develop a forecast of revenues and costs which might seem to be entirely reasonable. However, as is pointed out in most articles on the subject, an operating forecast for a new business cannot be divorced from the location of the business; the type of product it sells; the market the business serves; the physical facilities and the actual capabilities of the owners and employees. Guidelines are just that; individual circumstances will determine their relevance.

BE SURE OF YOUR SOURCES

If you were to hear a statement like "The average annual profit of businesses at Kumquat is $40,000" your first reaction might be "Kumquat, here I come!". Only after further questioning might you find out that this figure includes the large profits of, say, a major mining company and the more modest profits of many other businesses. The vital point to remember is that "averages" and other statistical information sometimes can be meaningless. In order to make such information meaningful it is important that you know the basis on which the information being "averaged" was prepared. It is also important that you know what information is meant to be conveyed by the statistics you are using. Statistics Canada's booklet "How to Profit from Facts" which is listed in I.D.B. Pamphlet No. 1 provides interesting examples of how statistical information can be utilized and some helpful advice on how to use Statistics Canada's services.

DON'T THROW AWAY YOUR MONEY

If you are going to put your life's savings into starting a business, you certainly don't intend to lose this investment because the business fails. You expect the business to make reasonable profits and give a return on your investment. You may consider the opportunity "to be your own boss" to be part of this return. Or you may be interested in making substantial profits. Either way, you will want to obtain some indication of the business' chances of providing the return you wish. It is therefore important that the future of the business be considered very closely before you invest your money in it. Even if it means spending a few dollars on postage or taking up time you could be spending doing something else, an investment in a carefully prepared operating forecast can mean a difference of many times that amount in profits for your business or the saving of an investment that would otherwise be lost.

THE OPERATING FORECAST – NOT A "MAGIC POTION"

Even after you have considered the whole matter quite exhaustively, you will likely find "iffy" areas remaining in your forecast. This will be so with many small businesses, especially those that involve new technological developments or new products. Even so, information obtained in preparing an operating forecast can eliminate some of the areas of uncertainty which can cause a business' quick failure if it is established with a "Damn the torpedoes!" approach. All too frequently, the business established with this approach does not fail because of a single catastrophic event. Rather, it slips away into quicksand and will not only disappear itself, but will cause "close calls" or equally unceremonious deaths for some of the other businesses which have supported it, for instance those giving it credit.

There will likely always be business failures, from a number of causes, and preparation of an operating forecast will not eliminate the risks of failure. Rather, the forecast can provide some further insight into the possible risks involved and a more informed basis on

which to judge them. It can reduce the number of surprises that might lie ahead for your business.

PREPARING THE FORECAST:

As was stated earlier, an operating forecast can be described as the operating statement which a businessman would expect to see at the end of the period for which the forecast is prepared. An operating statement might have the following form:

OPERATING STATEMENT — XYZ CO.

REVENUES —		______
EXPENSES		
Material cost (the cost to you of goods which you expect to sell during the year)	______	
Wages and benefits	______	
Depreciation	______	
Overhead (light, power, heat & water)	______	
Equipment repairs	______	
Delivery expenses	______	
Advertising	______	
Insurance & taxes	______	
Rent	______	
Interest	______	
Cash withdrawals by owners	______	
Total expenses & cash withdrawals		______
Net Profit		______

You would then want to fill in whatever amounts you would expect to see opposite these items for a year's operation after your project is completed. It may be, of course, that some of the above headings would not be suitable for your kind of business, or that others should be added, but the above example illustrates how you should proceed in setting up an operating forecast.

MAJOR ITEMS TO BE CONSIDERED

The following questions are only some of those which you will want answered in establishing a new business:

The Market:

1. Who will your customers be? The type of business you are considering will, in part, determine the answer to this question. If you are thinking of a fishing camp, your market will be the angler. If you want to make widgets, you would need to know who uses them. In the case of the widget manufacturer, for example, additional questions arise from the initial question:

(a) Is the market for widgets growing or contracting?

(b) If your widget is superior in say, wearing qualities, a further question might be: "Will a longer-wearing widget be attractive to these customers?" The longer-wearing widget may be of interest to the users. On the other hand, though, you might find that your possible customers are not interested in a longer-wearing widget, more expensive than those they now use, because the existing type of widget lasts as long as the equipment in which it is used. It might not make sense for prospective customers to purchase a product they do not really need.

(c) Where are the customers located? This may affect your decision on location of the business; advertising; how many salesmen to employ.

(d) How do the customers order? Regularly or irregularly? In a few large orders or several small ones? What is the frequency of "rush" orders? Answers to these questions will affect your inventory requirements, the scheduling of production and possibly the number of employees you will require.

2. *Prices:*

   What are the prices of competitive products? Do these prices include freight costs? Are discounts given by com-

petitive business? What price structure do you need in order to make reasonable profits?

3. *Material:*

   What will be the cost of the materials you need? How well established are your suppliers? What is their reputation for quality, service and delivery?

4. *Competition:*

   Who are your competitors? Are they large or small companies? How are they likely to respond to your company's entry into the widget-making business? Are they likely to cut prices of their own product, improve service or develop their own longer-lasting widget in response to your possible threat to their business? How long might it take them to develop such a widget? In other words, how much time do you have to become an established widget supplier? Could you still compete effectively if competitors were to "take a run" at you? Can they afford to do so? How many widgets can you sell and at what price?

5. *Facilities and Equipment:*

   What kind of facilities do you need? What are the costs of facilities and equipment? What are the relative costs of leasing and purchasing facilities and equipment? Is adequate equipment available? When, and under what conditions (warranty, delivery, etc.) can it be obtained? What are the reputations of the various manufacturers of the equipment?

6. *Employees:*

   What skills will your employees need? If you have decided on a location where you would prefer to establish your business, is there an adequate supply of possible employees with the skills you need? Can these skills be readily taught? Is there a training facility in the area or will you have to do the training yourself? What wage rates and benefits will you have to pay? What relationships do other businesses in the area have with their employees? Will you pay by the hour or on some other basis, for example, piecework?

7. *Production Costs:*

   How much will the material to make a widget cost? Is there any difference in material costs for different numbers of widgets produced? What will power cost and how much will be needed to operate your equipment, and heat and light your facilities? How many widgets can an employee produce? How many widgets do you need each employee to produce to sell the volume expected? What regulatory authorities will you have to deal with? What are the regulations you will have to obey? What, if anything, will adherence to these regulations cost?

8. *Financial:*

   What kind of record-keeping system should you have? Will you need a bookkeeper? a full-time accountant? If you need to borrow money, can it be obtained? On what terms?

9. *Working Capital:*

   What inventory level will you need in raw materials? — finished product? What is the amount of accounts receivable you can expect to have on your books at any one time? What payment terms would apply? What are the payment terms of your suppliers? How long would it take for the purchased material to be sold as finished product? What proportion of your sales would be for cash or immediate payment? Is working capital support available if you need it?

This is by no means a complete list of the questions you will want answered if you are thinking of starting a new business, but it may give you an idea of the type of question that will occur. Plainly, they will only be answered after considerable effort. Your accountant, your banker, the industrial commissioner, the Board of Trade and various government offices may be able to help you.

When you have obtained the information you need, an operating forecast such as the one shown, could be constructed.

OPERATING FORECAST — XYZ WIDGET CO. FOR THE YEAR ENDING DEC. 31, 1972

Revenues: 1,000,000 widgets at 6½¢ each		$65,000
Expenses:		
Material at $0.03/widget	$30,000	
Wages & benefits, 3 employees at $5,000 per year	15,000	
Depreciation (on equipment costing $5,000)	1,000	
Overhead (Power, light, heat & water)	2,000	
Equipment repairs	500	
Delivery expenses	1,000	
Advertising	500	
Insurance & taxes	300	
Rent	2,400	
Interest	200	
	$52,900	
Plus: Cash withdrawals from the business by the owner	7,000	59,900
Net Profit:		$ 5,100

If the owner of the XYZ Widget Co. has obtained accurate information, he will already be provided with answers to many of the problems which might otherwise cause the business early difficulties. These problems could arise very quickly if he had simply been determined to "have my own business" and simply trusted in luck or his own capabilities to surmount them. While XYZ's success would not be guaranteed, its chances of success would be good because the owner was prepared not only to *work hard* at the business but, more important, was prepared to *think hard about it.*

MANAGING YOUR FIXED ASSETS

As a rule, some of the money you put into your small business is used to buy fixed assets. These are things that are needed to operate your business, but they are not bought for the purpose of selling them as products. Some of the most common examples of fixed assets are land, buildings, machinery, equipment, vehicles and furniture. They do not get used up, or consumed, in the same way as the materials used to produce the products or services for sale, but a part of their useful life goes into the production of each of your products or services. They can be expected to lose value as they wear out, or break or burn, or deteriorate in some way during their lifetime — all except land. Land does not depreciate, although in special cases, such as land containing mineral reserves, the underground value may become exhausted or "depleted".

Knowing what fixed assets you need, and how to look after them, will help you make the best use of your money in the business.

In I.D.B. Pamphlet No. 5 "Managing Your Current Assets" it is pointed out that current assets are listed on the left side of your balance sheet in the order of how close they are to cash, starting with cash itself. Fixed assets are also listed on the left side of your balance sheet, below the current assets, usually in the order of their expected useful life.

Assets with the longest expected life are listed first, for example:

Land	$ 2,000
Buildings	20,000
Furniture and fixtures	2,000
Machinery	10,000
Vehicles	3,500

The value shown initially on the balance sheet for each type of fixed asset is normally the cost, that is the original price paid by the business. However, every year it is normal practice to reduce

the "book value" of each fixed asset, i.e. the value shown on the balance sheet, by subtracting an amount for the "wearing out" that has occurred during the year, except for land. The amount is charged as an expense to the business for the year and is shown on the profit and loss statement for the year as "depreciation expense" or "depletion allowance".

There are various methods of calculating depreciation of fixed assets, but a full discussion of the subject is beyond the scope of this pamphlet. It is required that you use one method, "the diminishing balance method", to calculate the income tax payable by your business. This simply means that you reduce the book value of each fixed asset by a fixed percentage each year. The federal Income Tax Act stipulates what maximum percentage of book value you can charge as a tax-exempt business expense for each type of fixed asset. By this method the amount of depreciation charged keeps reducing year by year as the book value reduces each year.

Many businesses prefer to use other methods for their own records, even though they are still required to calculate their income tax separately, using the diminishing balance method. One of the simplest and most commonly used is "the straight-line method". By this method, it is assumed that the same amount of depreciation occurs during each year of the useful life of a fixed asset. If a new machine costing $1,000 is expected to be used for ten years and to have a salvage value of zero after that time, $100 of depreciation would be charged in each of the years used.

On the balance sheet, these yearly charges for depreciation are accumulated as follows:

		Book Value after Accumulated Depreciation
Land		2,000
Buildings	$20,000	
Less Accumulated Depreciation	2,000	18,000
Furniture and fixtures	2,000	
Less Accumulated Depreciation	200	1,800

Machinery and equipment	10,000	
Less Accumulated Depreciation	2,000	8,000
Vehicles	3,500	
Less Accumulated Depreciation	1,050	2,450

IVORY TOWER OR RAIN SHELTER

In estimating and planning what fixed assets are required for your business, the ideal is to avoid buying too much and too fancy, as well as too little and too austere. For a new business particularly, it is often advisable to rent a suitable building, if available on reasonable terms. Later, when the business is well established, when its building requirements are known more precisely and it is in a better position to repay a term loan, the purchase of a building may be more justifiable. Buildings don't produce profits in most types of business. They merely provide shelter for the employees and machines which do. There are important exceptions of course, such as the hotel-motel industry, where buildings house the customers. In such cases, attractive, comfortable buildings are needed right at the start.

Requirements for machinery and equipment can often be reduced also by contracting certain work out to other firms, or by leasing. Perhaps certain parts of your products can be made by others for final assembly at your plant.

Another consideration is whether suitable second-hand assets could be purchased. Even large companies often shop around for used machinery and other fixed assets to fill certain of their needs. These may cost more to operate, but less to finance.

LAND

The initial price is only one consideration when you are looking for land for your business location. Where is your market? Where do you get your materials and labour? Is the shape of the site suitable for your building and operation? Is there good access to it? Is it completely serviced? What are the taxes? Are there any zoning or other restrictions about building? Is parking space

adequate? Such considerations may be more important to the long-term success of your business than the initial price of land.

No matter what location you select, don't forget about future expansion. If the sales of your business increase 10 per cent per year, they will double about every seven and a half years. If they increase 15 per cent per year, they will double every five years. This kind of sales growth requires more space and other facilities regularly. Is your land site large enough for such growth, or alternatively, would it be feasible to move the business to a larger site in five or ten years?

BUILDINGS

Before selecting a building for your business, you should give careful thought to the arrangement of the machinery, equipment and work areas inside the building. A careful layout should be made on paper, using moveable blocks of heavy paper representing to scale every major piece of equipment, machinery, etc. in its location in the building. Picture in your mind how the people and materials will move in your building. Then move the "models" around on paper to give you the most efficient layout. This should result in a smooth flow of traffic without too much criss-crossing. It should also provide easy passage of goods into the receiving area and out of the shipping area. If you don't want to make your own plant layout, hire a consulting engineer to do it for you. But above all, do prepare a layout! Moving a machine on paper ahead of time is much cheaper than moving the actual machine from a bad location later. Why not visit a few buildings used for the same type of business? Study their layouts, and you may benefit from their experience, or from their oversights.

Don't forget about expansion again, either horizontal, or vertical, or both. If you expect to expand horizontally, your plans might call for a temporary wall on one side, adjoining the vacant land area on which you will expand. If you are thinking of vertical expansion, make sure the building columns are designed to support a future upper storey.

Common-purpose buildings are the most readily saleable, so avoid, if possible, any special features that would detract from the

building's attraction to other businesses. You might want to dell it or rent it sometime. Many standard pre-fabricated buildings are available to suit most purposes. These should be considered versus a custom-designed building.

You will want to consider carefully all of the services that your building will require. Heat, water, electric power, and waste disposal are standard services, of course. You will need to know what type and quantity of each of these services are needed before deciding on the equipment and distribution for your building. You may have to install pollutant controls for your type of business. You may also need air conditioning, refrigeration and special materials-handling equipment such as power conveyors. Suppliers of this equipment will help you select the best size for your purpose.

Choosing a suitable, fully-serviced building is one of the most important business decisions you will have to make. When you have considered all of your requirements in a preliminary way you will be wise to get professional help for the final design, obtaining of a construction contract by tender, and supervision of construction.

As mentioned earlier, the federal Income Tax Act allows you to charge each year, as a business expense which will not be taxed, an amount for the depreciation of your building, if it is owned by your business. Examples of the current maximum depreciation rates in use are 10 per cent per year on frame buildings and 5 per cent per year on brick or masonry buildings. These percentages are applied to the "book value" of the building, that is, the cost less the depreciation you have charged to date on the building, using the diminishing balance method.

Suppose you are considering the purchase of a warehouse building. Two new buildings of the same size are available, one of steel frame and brick construction, and the other of wood frame and siding. Which should you buy? There are several methods of comparing, in financial terms, the relative merits of alternative choices of fixed assets, such as buildings. The "Total Annual Cost" method is one you could use, and your comparison could take the following form:

	Building A Steel & Brick	Building B Wood
DATA		
Initial cost	$60,000	$28,000
Interest rate	9%	9%
Depreciation	5%	10%
Taxes	4%	4%
Fire insurance, annual, per $100		
Building	$1.00	$2.50
Contents (Value $30,000)	$1.25	$3.10
Business loss insurance	$600	$700
Operating cost disadvantage	—	$500
ANNUAL COST		
Interest	$ 5,400	$ 2,520
Depreciation	3,000	2,800
Taxes	2,400	1,120
Fire insurance, building	600	700
contents	375	930
Business loss insurance	600	700
Operating cost disadvantage	—	500
TOTAL ANNUAL COST	*$12,375*	*$ 9,270*

In this case the wooden building should be purchased because of its lower annual cost.

FURNITURE AND FIXTURES

You and your key employees need comfortable, quiet offices where your brains will function most effectively, and where you can conduct your business in an organized manner. But that should be the prime purpose of offices.

Of course, in some businesses it will be good business to "dress up" your office space, to introduce some artistic appeal, and to display the goods, workmanship and services of your business in

an appealing way. In such cases, some extra investment in furniture and fixtures is warranted. But don't overlook the fact that good service is usually a far more compelling force in attracting and keeping customers than luxurious, expensive office furniture.

MACHINERY AND EQUIPMENT

James Watt, who patented one of the first practical steam engines in 1769, said: "Of all things, but proverbially so in mechanics, the supreme excellence is simplicity." This is particularly true of machinery and equipment for a small business, where high initial costs and later maintenance costs for overly-sophisticated items may be prohibitive. In fact such machines may cause excessive stoppages of production, where a simpler version would keep running.

When selecting equipment you need to be specific in what it should do for you. Decide on this in detail, then start shopping. How many units of your product should the machine handle in a given time to meet your sales requirements? How many operators can you afford to run it? How much space is available for it? What quality does it need to be able to produce? There's probably a machine available to meet your basic requirements. So make the machine match your requirements. If you fall in love with a sophisticated machine first, and then try to make your plant match the requirements of the machine, you may waste some of the money you have invested in your business.

If you are manufacturing products, it is your machinery, equipment and employees that will make profits for your business — not land, buildings and furniture. Try to find simple, good quality machinery and equipment at the lowest cost rather than complicated, good quality items at high cost. Even the simple principle of steam power, discovered about 200 B.C., and put to practical use in steam engines by Thomas Newcomen, and then James Watt, over 200 years ago, is still used widely and efficiently in simple machines such as steam turbines for producing electrical power. Counting the beads on an abacus may be too slow for your accounting work. On the other hand, an electronic calculator may be a faster and costlier machine than you really need. A simple

manual adding machine might be the best answer for the limited needs of your small business.

Suppose you are considering the purchase of a machine for your business, for example, a power lathe for your machine shop. A common method for analysing such a purchase is the "payback method". Will the savings from the machine pay for the machine before it wears out? A lathe might be available for $4,000 that would last you 8 years and would save you $1,000 in labour each year. The payback period would be $\frac{\$4{,}000}{\$1{,}000} = 4$ years. This sounds attractive because the lathe would pay for itself in much less than its expected useful life. You should probably buy it. But is there a better buy available?

Another supplier will sell you a more versatile lathe for $6,000 that should last 10 years and should save you $1,500 in labour each year. The payback period would be $\frac{\$6{,}000}{\$1{,}500} = 4$ years, the same as the first example, so this one sounds attractive too. Now what do you do to choose between them? Look at the expected useful life of each machine. The $4,000 lathe will pay for itself in 4 years, or 50 per cent of its useful life of 8 years. But the $6,000 lathe will pay for itself in 4 years, only 40 per cent of its useful life of 10 years. So buy the $6,000 machine, which pays for itself relatively sooner in its useful life.

VEHICLES

Does your business need to own vehicles at all? Probably. A car for you at least, and for your salesman, if you have one. Have you considered renting vehicles, particularly if you require one or two new ones all the time for sales purposes? On the other hand, if you need a light delivery truck, you would probably use it for several years and then sell it for scrap or trade it in. Owning, rather than renting, such a vehicle would probably be wise because the average annual cost over its lifetime would be quite low.

Owning vehicles involves your business in two kinds of expenses, "fixed expenses" and "variable expenses". The fixed expenses for a vehicle are those you will have to pay regardless of

how much you use the vehicle, even if it is just sitting in your parking lot most of the time. Such things as insurance, license fees, seasonal servicing, and of course depreciation. Generally speaking, the more expensive vehicles have the higher fixed expenses. Variable expenses are those which will vary according to the number of miles a vehicle is driven. Such things as the cost of fuel, oil, tires, spark plugs and other replacement parts. Generally speaking the farther a vehicle is driven, the lower the average variable expenses per mile. And a more expensive vehicle does not necessarily have much higher variable expenses than a cheaper one.

Suppose you are trying to decide between the purchase of a \$3,000 car or the purchase of a \$5,000 car for your salesman. To help you decide which would best suit the needs of your business, you could compare the main expected fixed and variable expenses for each, assuming for example, that the car might be replaced in three years with a certain trade-in value. The comparison could take the following form:

	Car A Price $3,000	Car B Price $5,000
Replacement period	3 years	3 years
Trade-in value in 3 years (estimated)	$1,500	$2,500
Cash outlay at replacement	$1,500	$2,500
Fixed Expenses - (Average per year)		
Insurance	$ 130	$ 175
License	25	45
Seasonal servicing	25	35
Car washing (20 per year at $1.75)	35	35
Replacement (⅓ of cash outlay at replacement)	500	833
Interest on investment at 7 per cent	210	350
Miscellaneous (battery replacement, parking, etc.)	60	80
Total Fixed Expenses	$ 985	$1,553
Variable Expenses		
Fuel (18 miles/gal. at 45¢ gal.)	$0.025 per mile	$0.025 per mile
Tire replacement (4 tires every 25,000 miles)	*0.004 " "	0.005 " "
Replacement of oil, oil filters, spark plugs	0.003 " "	0.003 " "
Snow tires (2 at $25 each every 30,000 miles)	0.002 " "	0.002 " "
Replacement of shock absorbers	0.002 " "	0.002 " "
Miscellaneous garage repairs ($100/10,000 miles)	0.010 " "	0.010 " "
Total Variable Expenses	$0.046 per mile	$0.047 per.mile
	* ($20.00 per tire)	($30.00 per tire)

Summary — Cost of Car Operation per mile

Miles Driven Per Year	Fixed Expenses Per Mile		Variable Expenses Per Mile		Total Expenses Per Mile	
	Car A	Car B	Car A	Car B	Car A	Car B
30,000	$0.033	$0.052	$0.046	$0.047	$0.079	0.099
20,000	0.049	0.078	0.046	0.047	0.095	0.125
15,000	0.066	0.104	0.046	0.047	0.112	0.151
10,000	0.098	0.155	0.046	0.047	0.144	0.202
5,000	0.197	0.311	0.046	0.047	0.243	0.358

The figures used are for illustrative purposes only and you would have to select those applicable to your own situation. They do show, though, that the operating cost at low mileage is very high. At 5000 miles of driving per year, Car A in the example costs about 24 cents per mile, and Car B, the $5,000 model, costs about 36 cents per mile. Car rental rates are well below these figures. The example also shows that at high mileages of 20,000 or 30,000 miles per year, the higher-priced model becomes relatively more attractive, i.e. the cost per mile is not much higher than for the cheaper model. Also, at these higher mileages, car rental rates would be less attractive in comparison. Applying this type of comparison to your own situation should lead you to a prudent decision on the buying or renting of vehicles.

INTANGIBLE ASSETS

The fixed assets discussed so far are tangible fixed assets, that is, they have physical substance. Fixed assets can also be intangible, for example, things used in the operation of the business which do not have physical properties, such as patents or copyrights. The value of such intangible assets is in the rights which their possession gives to your business. Even intangible assets have a limited useful life and their value, or cost, in most cases, may be charged off gradually as a business expense during their estimated useful life. This systematic "write-off" for intangible assets is usually called "amortization". It is a similar idea to "depreciation" for tangible fixed assets (except "natural resource"

fixed assets, such as mineral or timber rights, for which the term "depletion" is used).

Some intangible fixed assets may have an indefinite useful life, for example, good will, rights, and franchises without a termination date. These may also be amortized; otherwise they might have the effect of overstating your balance sheet at a later date. Such assets as goodwill have been known to become valueless during the life of a business.

CONCLUSION

The fixed assets of your business are not sold like products or services, but they have a direct bearing on your selling prices. A part of their original value goes into the production of your goods or services during their useful life, except in the case of land.

This "wearing out" of fixed assets, or depreciation, is a business expense. It is an allowable deduction from the income of your business before taxation.

Before choosing fixed assets you should consider not only their cost, but the future expansion needs of your business. Alternatives, such as leasing certain fixed assets, or purchasing used items should also be considered. Emphasis should be put on fixed assets that will produce profits for your business.

Good management of your fixed assets will keep your fixed expenses, such as interest and depreciation, under control and your selling prices competitive.

MANAGING YOUR CASH

Pamphlet No. 5 in this series, titled "Managing Your Current Assets" discusses cash as part of the current assets of a business. Accounts receivable and inventories are other current assets which should eventually be turned into cash; then into other assets, used to reduce debts, or withdrawn from the business.

It is not uncommon for businesses to make profits and yet to be in trouble because they don't have the ready cash to pay their current bills. You won't stay in business very long if bills go unpaid, so managing cash is a vitally important part of managing your business.

CASH MANAGEMENT — ITS PURPOSE

The purpose of good cash management is to have enough cash — in the till, in the bank, or readily available elsewhere — to meet your expenses and bills when they come due. You should not have too much cash, or the resources of the business will not be used as profitably as possible. Surplus cash in the till is doing nothing but sitting there, and may tempt some enterprising fellow to bring your cash supply and demand into closer alignment by relieving you of some of it. He might, of course, be very upset if there's nothing in the till, and would doubtless be unimpressed if you were to tell him that according to your cash flow forecast you really had no need for "till money" until tomorrow.

Cash for your business operation is like many other things — it's better to have too much than too little. But it's better still to have the right amount. The purpose of cash management is to determine as closely as possible just what the right amount is.

HOW TO MANAGE CASH

There are a number of ways you can control the cash which passes through your hands:

a) At the till — till and tape balances should be balanced. Cheques, which you may want to personally approve before

they are honoured, should be deposited with your bank as soon as possible.

b) At the "petty cash" box — you will want to ensure that the amount which you have set as a petty cash reserve is always there in either cash or vouchers.

c) At the bank — you will want to reconcile your records and your bank's records of deposits and withdrawals, and provide for cheques which you have issued but which have not yet reached your bank.

These are activities which you would do on a regular basis.

But these are only pieces of the "big picture" — the overall financial position of your business. Your business might have cash of $500 on hand after providing for cheques outstanding, and you might feel reasonably well off. You might have forgotten, however, that a $1,000 note on a piece of equipment comes due next month. The equipment supplier might be a little disturbed if you say you don't have the money to pay him. A fast trip to a lender might result in a loan to pay the supplier, but this can create needless wear and tear on your physique and probably would not give the lender a great deal of faith in your management ability.

Some wear and tear, and possibly some sleepless nights, can be avoided if, by preparing a cash flow forecast, you have a reasonably good idea of what cash you will need, and when and from where it is coming.

THE CASH FLOW STATEMENT VS. THE STATEMENT OF PROFIT AND LOSS (OPERATING STATEMENT)

There is a basic distinction to be made between a cash flow statement or forecast and the statement of profit and loss (operating statement) or operating forecast. The cash flow statement shows all **cash receipts** from every source as they are **received** and all **cash payments** by the business as they are **made.** The operating statement shows **sales** and **expenses** as they **occur** but in certain cases before cash has actually been received or paid; it does not show changes in the business' cash position; and does not necessarily show all cash transactions.

While instances of some of these differences will be given later in this pamphlet, the following example will show a major distinction between these two financial tools:

> If you sell $100 worth of goods on March 15th and receive payment in cash at the time of sale, the $100 would appear as a sale on your profit and loss statement for March and would also be a cash receipt on your cash flow statement for March.
>
> However, if you sell $100 worth of goods on March 15th on 30-day terms and collect the $100 on April 15th, this would appear as a sale on your March profit and loss statement but would not appear as a cash receipt on your cash flow statement until April.

BASICS OF THE CASH FLOW FORECAST

Basically the cash flow forecast or cash flow budget simply sets out the business' expected timing and amounts of cash income and cash payments; that is, the cash flow through the business. This is sometimes referred to as the "receipts and disbursement" method of cash flow forecasting.

Let's take, for example, the case of a tourist camp operator, the Big North Tourist Camp, and assume the following:

1. His customers all pay him in cash.
2. He makes all his payments in cash.

Assume also that he has been in operation for a year, 1972, and then went back through his records for 1972 to see what his cash flow had been. If he started the year with $500 cash on hand and in the bank, the cash flow statement for the year might look like this:

Cash balance January 1, 1972	$ 500
Cash in — January 1 to December 31, 1972	25,000
Cash out — January 1 to December 31, 1972	22,000
Cash balance January 1, 1973	3,500

This shows a $3,000 increase in cash within a year, but among other things, it doesn't tell us where the money came from, or where cash was spent. The business' financial statements would tell us this.

Let's suppose, though, that this tourist camp operator wants to know what the business' cash flow position looked like on a monthly basis for the past year:

CASH FLOW STATEMENT — BIG NORTH TOURIST CAMP
January, 1972 to December, 1972

	JAN. 1972	FEB. 1972	MAR. 1972	APR. 1972	MAY 1972	JUNE 1972	JULY 1972	AUG. 1972	SEPT. 1972	OCT. 1972	NOV. 1972	DEC. 1972
Cash, beginning of month	500	500	500	500	200	—	700	3,700	6,700	6,700	5,700	4,200
Cash in (receipts)	—	—	—	—	—	5,000	9,000	9,000	2,000	—	—	—
Cash, paid out (Disbursements)	—	—	—	300	200	4,300	6,000	6,000	2,000	1,000	1,500	700
Cash on hand, end of month	500	500	500	200	—	700	3,700	6,700	6,700	5,700	4,200	3,500

The cash flow statement shows the following:

1. Cash came into the business in only 4 months — June to September inclusive — the months when the tourist camp was open for business.

2. Cash was paid out in 9 months. Payments made in October, November and December might reflect payment for work needed to winterize the camp, to make repairs and possibly, to add another cabin.

3. Payments in the spring might reflect cost incurred in preparing the camp for opening; payments made in the summer might reflect payments for food, hired help, fuel, interest and principal on loan payments, etc.

4. Note that at the end of May the business had no cash on hand. This situation changed quickly by the end of June when the business had $700 cash.

With this experience to go by, the owner of this business could easily prepare a cash flow forecast for the coming tourist season. He might expect revenues to increase from $25,000 to $30,000 if he opens earlier, with cash costs increasing by $3,500 if he opens the camp for business in May, 1973. The cash flow forecast might look like this:

CASH FLOW STATEMENT — BIG NORTH TOURIST CAMP

January 1st, 1973 — December 31st, 1973

	JAN. 1973	FEB. 1973	MAR. 1973	APR. 1973	MAY 1973	JUNE 1973	JULY 1973	AUG. 1973	SEPT. 1973	OCT. 1973	NOV. 1973	DEC. 1973
Cash, beginning of month	3,500	3,500	3,500	3,000	2,500	3,000	4,200	7,700	10,700	11,200	10,200	8,700
Cash in (receipts)	—	—	—	—	2,000	6,000	10,000	9,000	3,000	—	—	—
Cash, paid out (disbursements)	—	—	500	500	1,500	4,800	6,500	6,000	2,500	1,000	1,500	700
Cash on hand, end of month	3,500	3,500	3,000	2,500	3,000	4,200	7,700	10,700	11,200	10,200	8,700	8,000

This cash flow forecast might raise the following questions:

1. Since the business will not need cash until March, (the first "cash, paid out" is $500 in March) possibly the present cash balance, or most of it, should be put in an interest-bearing account.

2. Since the minimum cash position expected will be $2,500 at the end of April, the business seems to have sufficient resources to permit the purchase of some other assets which might be useful in its operation, before cash income for the year actually starts to come in. Possibly, too, the owner might be satisfied that he can readily afford to withdraw from the business the $500 or so he needs to escape to the South for a week or two before his busy season begins.

3. If the business operations are as successful as expected, by the end of the year the business will have $8,000 cash on hand. The owner might wish to plan how to extend the season for his operation, with such resources available for this purpose.

4. Once the business gets into its busy season, monthly cash receipts are forecast to be well in excess of monthly cash disbursements. The owner might decide that a $500 cash balance in the business' chequing account at the bank would be a large enough reserve to provide for contingencies during the summer months. He might therefore decide that any month-end cash balance over $500 would be put in an interest-bearing account until the operating season is over. This could ensure that while this money is earning income it is also readily available for use in the business in the event of an emergency.

CATEGORIES OF CASH RECEIPTS AND DISBURSEMENTS

The cash flow statement and forecast shown on the preceding pages do not show the various sources of cash, nor the uses to which cash was put. When he was preparing the cash flow forecast, this businessman might have broken down cash income in the following way:

- Cabin rentals
- Meals
- Guide fees
- Fishing tackle sales & rentals
- Cruise fees
- Investment

The cash flow statement is different from the profit and loss statement of the business in that it shows all expected cash income from every source. If you invest more money in your business, this will not show up as income to the business on your statement of profit and loss but will show up as an increase in your capital on the business' balance sheet. It becomes part of the total supply of cash used by the business during the year and should therefore be included in the cash flow statement or forecast as a cash receipt. Similarly, if you anticipate selling some of the business' fixed assets, the expected receipts should be brought into your cash flow forecast.

Similarly, the businessman operating Big North Tourist Camp might have broken down his expected cash disbursements into such categories as the following:

- Food purchases
- Guides' wages
- Kitchen staff wages
- Other wages
- Repair costs
- Fuel
- Interest
- Linen & other miscellaneous supplies

- Cash withdrawals (by the owner)
- Loan payments (principal)
- Capital expenditures, for example, a new cabin

Again the list of cash disbursements will not be the same as the list used in your statement of profit and loss. Because they come out of earnings, loan principal payments and cash payments made for depreciable fixed assets will not show as part of the business expenses on your statement of profit and loss. Since they are cash payments, they will need to be taken into account when preparing your cash flow forecast. Depreciation is not included in the list of disbursements because it is not a cash outlay.

USING A CASH FLOW FORECAST

Many businesses compile cash flow forecasts which are far more detailed than the one outlined above. Some businesses prepare cash flow forecasts for periods longer than a year, broken down into periods shorter than a month. Generally, though, a cash flow forecast is done for a year on a monthly basis and is, of course, revised if required by developments during the year.

If your business is engaged in manufacturing, for example, it will undoubtedly be necessary for you to extend credit. You will also need to carry inventories of raw materials and finished products. You will possibly obtain credit from your suppliers, and your bank, and you may also have a loan from a mortgage lender. You may need to replace equipment or buy new machinery or other fixed assets.

To make a cash flow forecast for such a business, you would need to have some idea of what your revenues would be, when your products are sold (for example, the bulk of your sales might occur in the spring and fall months). You would need to know what proportion of these sales might be cash sales. You would need to know what proportion of these sales are for credit, what your credit terms are, what proportion of your customers abide by your credit terms and what proportion of your receivables take longer to collect as well as what proportion you may never collect. You would need to know when you must purchase raw materials and the credit terms of your suppliers.

You might find that at certain times in the year your business does not have sufficient cash on hand to meet its bills. You would then wish to arrange in advance for some temporary assistance from your bank to ensure that adequate cash would be available when needed.

SUMMARY

A business can operate profitably and yet have difficulties because it is starved for cash at certain times of the year. A cash flow forecast will help you predict this and will indicate what remedial action you might take, ahead of time, to avoid cash shortages, for example, the forecast will show what line of bank credit is needed.

A cash flow forecast shows the timing and amounts of all cash receipts and disbursements during the coming year. An operating forecast, which shows expected revenues and expenses for the year, does not indicate fluctuations in your cash position.

A cash flow forecast can tell you:

- when cash is needed
- how much cash is needed
- what cash the business may have available to buy fixed assets or whether it should borrow this money
- whether cash should be invested outside the business for a time until it is needed

No matter how time-consuming it may seem, a cash flow forecast can be very helpful in planning for the future of your business. It can be especially useful in managing one of your business' most vital assets — cash.

WORKING CAPITAL

Bob Leduc looked at the papers his accountant had just sent him. One sheet, marked Schedule 2, puzzled him. The heading read "Changes in Working Capital between April 1, 1972 and March 31, 1973."

Bob was a dry cleaner, a good one. He had proven this by running his dry cleaning shop profitably in Minton for nine years. But he was no accountant. The phrase "working capital" was just words without a message. He had heard his good friend, Debra Drew, talk about it. Debbie ran the drug store next door. Maybe druggists learned about working capital at college. Occasionally Debbie grumbled that she was short of working capital, even though her busy store never seemed short of anything.

Bob turned back a page. The top of it read:

LEDUC CLEANERS
BALANCE SHEET AS AT MARCH 31, 1973

ASSETS		LIABILITIES	
	$		$
Cash	100	Bank advances	3,000
Accounts receivable	500	Accounts payable	5,000
Materials & supplies, at cost	800	Mortgage-current instalments	3,000
Total current assets	1,400	Total current liabilities	11,000

This seemed easy enough to follow. All of Bob's customers paid for their cleaning with cash, except the supermarket. Their account for dry cleaning of uniforms was the only account receivable. The inventory of materials and supplies was all there in the shop: cleaning materials, rolls of plastic, hangers, labels, cartons. Not many current assets, but everything needed to run the business.

Bob's business had a $5,000 line of credit from the Foundation Bank down the street. He only used it at certain times during each year and his borrowings had never reached $5,000. So the

$3,000 owing to the bank was a problem. Accounts payable of $5,000 looked a little high. Bob decided to have a closer look at that one. So he skipped on to the mortgage. The $3,000 was a year's payments on his 10-year loan, originally for $30,000, from the I.D.B., for his new equipment. There wasn't much he could do about that.

Back to accounts payable. Bob knew that he had grossed $150,000 for the year, or an average of $12,500 per month. He also knew that his purchases of materials and supplies normally amounted to about 10% of his revenues. To sell $12,500 in a month he would have had to buy $1,250 of materials and supplies. The accounts payable figure of $5,000 on the balance sheet would therefore be about four months' purchases. All of his suppliers gave him 30-day terms so he must be behind in paying some of them. Or could it be that his monthly sales in February and March had been well above the $12,500 average, requiring heavier purchasing? Or could there be accounts included that were not materials and supplies?

After checking his monthly sales figures and his list of accounts payable at March 31st, Bob found the answer. Sales were $12,900 in February and $11,800 in March. Nothing abnormal about that. But in the accounts payable list all items were materials and supplies, except one, a bill for $3,800 from Grant Electric for his new outdoor sign and new lighting system in the shop. Unpaid bills for normal purchases of materials and supplies were therefore only $1,200 of the $5,000 accounts payable. This was in line with the 30-day terms available.

Debra Drew, the druggist, had said that working capital was the difference between current assets and current liabilities, and that she liked to have twice as many current assets as current liabilities in her drug store business. She had also said that she had trouble in achieving this.

Bob thought about his own situation. He had just convinced himself that his own current assets and current liabilities were in pretty fair shape. But the current liabilities of $11,000 were far greater than the current assets of $1,400. Leduc Cleaners had a working capital deficit rather than a surplus. Yet nothing seemed wrong. Could it be that each business has its own special requirements for working capital? And what do we really mean when we

say that working capital is the difference between current assets and current liabilities? What message should this give to the person running the business?

WHAT IS WORKING CAPITAL?

As noted in I.D.B. Pamphlet No. 5 "Managing Your Current Assets", current assets are cash and things that can be converted to cash in the near future, usually within twelve months. They are "liquid" assets.

Current liabilities are debts which have to be paid in the near future, normally within twelve months. They are paid by the normal circulation of cash through the business. The main circulation results from converting cash to inventories to accounts receivable and back to cash. In the case of cash sales, the cycle is even shorter: cash to inventories and back to cash when a sale is made. Because of the mark-up of the inventory, and of the service sometimes sold with the inventory, the amount of cash received from a sale is, hopefully, greater than the amount spent on the inventory. Current assets, then, pay for current liabilities.

The ability of a business to pay its current debts on time therefore depends on the amount and timing of this cash circulation from one type of current asset to another: cash to inventory to receivables to cash to inventory to ....If this circulation is fast compared to the time available for payment of accounts payable owing to suppliers, the business will have cash to pay its debts on time, with only a minimum of current assets on hand. At any time, the balance sheet will show a relatively small difference between total current assets and total current liabilities, that is, a small amount of working capital. In fact, in a business with a high proportion of cash sales, but with credit terms for its purchases, such as Leduc Cleaners, current liabilities might often be greater than current assets.

Let's take a simple example. Supposing Bob Leduc buys 100 coat hangers. He receives them, along with the invoice specifying 30-day terms, on a Monday. By Friday of the same week they have all been "sold" as part of his dry cleaning service, and he has been paid in cash. He doesn't have to pay for the hangers for

another 26 days so he has cash available to pay other bills. He can order more hangers or other supplies and receive cash for them from his customers, and then pay for the first 100 hangers. He has no need for large accumulations of cash, supplies or other current assets in order to pay his bills on time, that is, he needs only a small amount of working capital.

So working capital means more than just the arithmetical difference between current assets and current liabilities to the person managing a business. *It is really a reflection of the health of each current asset and each current liability under the operating conditions that exist in that business, and none other.* The amount of working capital needed in a business is that which results from each current asset and each current liability being at a manageable level, for example no overdue accounts payable.

Most types of businesses do require a working capital surplus, that is, more current assets than current liabilities, because they require large, varied inventories, including slow-moving items, and because they offer credit to their customers, resulting in accounts receivable as a normal fact of doing business. It is the amounts of these and the timing of the operating cycle in each business that determines what amount of working capital is needed. The small business operator needs to know what constitutes a manageable or comfortable level for each of these items in his business. Relying on some arbitrary ratio of current assets to current liabilities can be quite misleading and even wasteful of the assets of the business.

HOW MUCH DO YOU NEED?

Bob Leduc was right. The working capital deficit shown on his March 31 balance sheet was satisfactory for his business at its present sales volume. It provided for payment of current debts as they fell due and it provided the necessary supplies to do business efficiently.

If Bob had tried to predict in January what working capital he should have by March 31 for a sales volume of about $12,500 a month he probably would have estimated as follows:

	$		$
CASH (nominal balance)	100	BANK ADVANCES (half of full line of credit)	2,500
ACCOUNTS RECEIVABLE (1 month's billings to supermarket)	500	ACCOUNTS PAYABLE (30 days' purchases)	1,250
MATERIALS & SUPPLIES (for 15 days, based on purchases of $1,250/month)	625	PAYABLE - Grant Electric	3,800
		Mortgage - Current	3,000
TOTAL CURRENT ASSETS	1,225	TOTAL CURRENT LIABILITIES	10,550

This estimate would have shown him that a working capital deficit of $9,325 would be satisfactory, with each current item at a tolerable level for the business and its creditors. The figures in the estimate are very close to those which actually existed at March 31 as shown on page 1.

Estimating the working capital requirements of a business requires estimating a workable amount for each current asset and current liability *for that business*. To make a meaningful estimate requires answers to the following questions:

1. What cash balance is necessary to cover day-to-day needs?
2. What are the receivables normally composed of and what is their likely recovery pattern, in relation to monthly sales? How many "days sales" will normally be awaiting payment?
3. What inventories are required to assure uninterrupted operations at the expected volume of business?
4. What bank credit is available?
5. What terms are available from suppliers and what purchases will be needed on these terms at the expected sales volume?
6. Are there any other current liabilities of significant amounts that will become due during the period considered, e.g.,

mortgage or lien payments, and in Bob's case, the bill for $3,800 from Grant Electric?

WHAT IF SALES INCREASE?

Many profitable businesses, including Debra Drew's drug store, find their progress hampered at times because of a "shortage of working capital." Their purchasing power diminishes and their credit reputation may even be affected because they cannot pay their bills on time in accordance with the terms available from their suppliers. This sometimes occurs with businesses experiencing a steady growth in sales, when additional working capital has not been provided to support a higher sales volume. What working capital is required when sales volume changes?

Changes in sales volume may occur throughout the seasons of every year without a significant change in annual sales. That is one consideration. The other situation is a significant increase in annual sales due to an overall expansion of business. Both situations warrant careful consideration of working capital requirements.

First let us consider the working capital needs of a seasonal business in which monthly sales vary quite widely during a normal 12-month business year. The critical period will be the peak sales period, the months when accounts receivable and inventories will be highest and support from bank borrowings and suppliers will be heaviest.

Debra Drew's drug store had sales of about $240,000 in each of the past three years, that is an average of about $20,000 per month. In each of those years her December sales were highest, at about $30,000. At June 30th, 1973 her balance sheet showed:

DREW DRUGS
BALANCE SHEET AS AT JUNE 30, 1973

ASSETS		LIABILITIES	
	$		$
Cash	500	Bank advances	5,000
Accounts receivable	4,000	Accounts payable	25,000
Inventory	40,000		
Total current assets	44,500	Total current liabilities	30,000

Sales in June were $20,000 and Debra found this situation quite workable. But what working capital would she need next December? She always seemed short at that time each year.

Debra decided to estimate what her current assets and current liabilities would be at December 31st.

At June 30th her business had $14,500 of working capital, as shown above. She drew up an estimate of her balance sheet (current portion) for December 31st, 1973, based on a $30,000 sales level, as follows:

	$		$
CASH	500	BANK ADVANCES (limit of her credit)	7,000
RECEIVABLES (50% more than June 30)	6,000	ACCOUNTS PAYABLE (50% more than June 30)	37,500
INVENTORY (50% more than June 30)	60,000		
TOTAL CURRENT ASSETS	66,500	TOTAL CURRENT LIABILITIES	44,500

This showed she would need $22,000 working capital at December 31st, but she only had $14,500 at June 30th. The same old story, not enough working capital in December. Where could she obtain another $7,500 before December?

One source would be the profits of the business from June to December. The business had been generating a cash gain (net profit plus depreciation) of only $800 per month during the past three years. If this continued from June 30, 1973 to December 31, 1973, it would total $4,800, assuming none of it would have to be spent during that period on such things as fixed assets or mortgage payments. Working capital would then increase by this amount, from $14,500 at June 30th to $19,300 by December 31st. But the estimated working capital requirement at December 31st is $22,000. So another $2,700 or so would have to be found.

Debra looked at her balance sheet again. Surely, with her good bank record the Foundation Bank would be willing to increase her line of credit. She would offer the bank a $20,000 paid-up personal life insurance policy as security. An increase in bank credit of $2,700 would probably solve her working capital problem for

next December. Debra remembered that this was all based on an estimate, so to allow for error and flexibility she applied for an increase in her line of credit from $7,000 to $12,000. This would give her access to $5,000 more bank credit, if needed. Her application was approved.

She summarized her situation as follows:

Actual working capital at June 30, 1973	$14,500
Estimated cash gain July 1 - Dec. 31, 1973	4,800
Estimated working capital Dec. 31, 1973	19,300
Working capital needed Dec. 31, 1973	
- using $7,000 line of credit	22,000
- using $12,000 line of credit	17,000

The new line of credit would assure a comfortable working capital position during the month of December next.

Debra then considered the second type of change in sales volume, moving up to a new plateau in annual sales. She was planning to open a second store in June, 1974 which should increase her total sales by $100,000 to $340,000 in the first year. So December 1974 would bring another working capital crisis. She expected the second store would just break even the first year so the cash gain during 1974 would continue to be $800 per month. She estimated that the combined balance sheet (current portion) for both stores at December 31st, 1974 would look like:

	$		$
Cash	800	Bank advances	12,000
Receivables	8,500	Accounts payable	53,000
Inventory	85,000		
	94,300		65,000

She would need $29,300 working capital, $12,300 more than the $17,000 needed December 31st, 1973, in both cases using the full $12,000 line of credit. Should she try to find some new money herself to invest in the business, or again rely on bank or other credit?

She remembered that the business would gain cash of about 12 × $800 = $9,600 during 1974. She decided that she would invest another $5,000 in the business in 1974 to bolster the working capital. She again summarized her thoughts as follows:

Estimated working capital Dec. 31, 1973 (using new $12,000 bank credit)	$17,000
Estimated cash gain Jan. 1 - Dec. 31, 1974	9,600
New investment by owner during 1974	5,000
Estimated working capital available Dec. 31, 1974	31,600
Working capital required on Dec. 31, 1974 (estimated)	29,300

Debra was satisfied that this plan would satisfy the working capital needs of the business during the peak period of December 1974. It provided a small cushion of $2,300 more than the estimated requirement, in case she did not quite meet the estimated figures.

ADVANTAGES OF ADEQUATE WORKING CAPITAL

Leduc Cleaners and Drew Drugs are typical small businesses with their own unique requirements for working capital. What is the main reason for the very different working capital needs of each of them? In Bob Leduc's case his inventory requirements are small, about $800 to be paid for within 30 days. Debra Drew, on the other hand, had to have an inventory of $40,000, peaking to $60,000 in December, and she too had to pay her suppliers on 30-day terms. Furthermore, Debra "carried" $4,000 to $6,000 in accounts receivable, as opposed to Bob's $500. Both businesses have had a successful record, but despite this, serious shortages of working capital could have caused them difficulty, even to the point of failure.

A business which provides for a strong working capital position, particularly at periods of peak sales, will maintain good purchasing power and will be able to buy its inventory requirements and essential services on the best terms. It will not have to jeopardize the quality of its products or services by purchasing sub-

standard materials. It will be able to take advantage of trade discounts when available and keep its costs and prices competitive. It will be able to insist on good deliveries of purchases and thus avoid stock shortages or over-stocking. Such a business can point its own way, rather than be directed by its creditors. Its credit reputation will be upheld. Cash will move smoothly into other current assets and back again without obstruction. The business will enjoy a healthy circulation.

CHANGES OF OWNERSHIP

INTRODUCTION

Each day several small Canadian businesses change hands. For buyers and sellers alike, such changes of ownership are major events. The process is complex. Clear understanding of it, and careful planning of each step are needed for a logical, unemotional decision. The transaction can then be closed in proper legal form, safe and fair for both parties.

This pamphlet outlines some of the key considerations involved in the change of ownership of a business. For simple illustration the case of a proprietorship is used, although similar considerations will apply to partnerships and to companies. In any case, the buyer and seller must be willing to invest enough effort in preliminary work to avoid waste of time, money and disappointment.

SELLING A SMALL BUSINESS

The seller has several ways of attracting prospective purchasers. More than one or all of the following common methods can be used to suit the circumstances:

- — Word-of-mouth, including suppliers
- — Newspaper advertising — classified ads section
- — Real estate broker
- — Trade publications.

The selection of the means used would be governed by the circumstances prompting the sale; the seller would have to decide whether prior publicity would harm the business and therefore adversely affect its price.

Word-of-mouth contact by itself is probably the least effective means, unless the seller knows of an interested party willing to negotiate.

Classified newspaper advertising is inexpensive and effective provided the ad is specific as to price, location and size of the business. The seller should decide whether he wants replies to his address, through a box number, by direct telephone or through an answering service.

Real estate brokers specializing in business opportunities can assist in finding and screening buyers and in ensuring all the proper legal steps are taken. The commission is often well spent in protecting the seller from wasted effort at all stages.

Trade publications are effective in reaching prospects directly interested in the type of business being sold. This method eliminates most of the frivolously minded.

If the seller puts himself in the place of the buyer, he can readily prepare and assemble the data a prudent investor would reasonably expect to be available to him. This material should include the following:

1. A written history of the business to the present and a statement of its potential.
2. Balance sheets and operating statements for prior years and a recent interim statement.
3. A written argument setting out the basis of establishing and evaluating the seller's asking price.

DETERMINING THE PRICE

Establishing a fair price is the biggest problem. The seller understandably tries to put a price on the effort and money he has invested in the business. But the buyer is mainly interested in the ability of the business to yield a fair return on his investment after giving him a reasonable salary. Therefore the present state and future potential interest him most, to determine whether the business will yield a return on investment at least equal to, if not better than, alternative sources. If such is not the case, the prospective buyer would be unlikely to offer more than the value of the **tangible assets.** As the term suggests, these are assets which can be touched, weighed or measured and have real value. He would not ascribe any value to "goodwill" which in one sense is directly related to the earning power and potential of the business.

The seller, then, must forget about his prior investment of money and effort and base his price realistically on present and future factors. He might select the following steps in determining his price formula:

(1) Establish the tangible net worth of the business (that is, assets less liabilities, ignoring any intangible assets such as goodwill).
(2) Estimate what dollar return — perhaps 10% — an investor would get on this amount if invested elsewhere with approximately the same degree of risk. This is called "earning power".
(3) Add a reasonable salary for the new owner.
(4) Establish from the operating statements the average annual net earnings before taxes (net profit before deducting owner's drawings) for the past few years. This gives a means of comparing the historical earnings with those the prospective buyer could get from alternative sources open to him. The trend of historical earnings is the key factor.
(5) Deduct the earning power (2) plus reasonable salary (3) from the average net earnings (4) to determine the business' "extra earning power".
(6) To value the intangibles, multiply (5) by the number of years of profitable operation. A well-established and successful business would justify using a factor of five or more; a less well-based enterprise might suggest a factor of three as appropriate.
(7) Final asking price = tangible net worth (1) plus value of intangibles (6)

Applications of the price formula described to evaluating two businesses up for sale are illustrated below:

		Business A	Business B
(1)	Tangible net worth	$40,000	$40,000
(2)	Earning power - 10% of (1)	4,000	4,000
(3)	Reasonable salary for owner	10,000	10,000
(4)	Average net earnings	16,000	12,000

(5)	Extra earning power (4) minus (2) and (3)	2,000	-2,000
(6)	Value of intangibles (5) times 5	10,000	Nil
(7)	Final asking price (1) plus (6)	$50,000	$40,000

In the case of Business A, we see the seller should get a substantial price of $10,000 for the intangibles (mainly "goodwill") because the business is well established and is probably earning more than the potential buyer would likely get elsewhere with comparable effort and risk. The buyer would in this example recover the cost of goodwill (6) in five years. The reasoning is that if the business continues to average $16,000 net earnings per year, the buyer will realize his 10% return of $4,000, his salary of $10,000 plus $2,000 extra earnings each year. This last amount would equal, in five years, the $10,000 he paid initially for the goodwill.

For Business B, there is no goodwill value because there is no extra earning power (5) and a prospective buyer might even conclude that the business was not worth its tangible net worth (1) because of the poor return on an investment of that size. Intangible assets often include patents, franchises, organization expense, trade marks and goodwill.

BUYING A SMALL BUSINESS

Most of the considerations the seller should examine apply equally to the buyer who firstly has to:-

1. Select the size and type of business best suited to his interests, his character, capital available and prior experience.
2. Seek out opportunities meeting his requirements.
3. Evaluate each opportunity.
4. Ensure the transaction is handled properly.

The selection of the type of business is a personal one about which advice could be obtained from banks or from acquaintances already in the same line of business.

The seeking of opportunities can be assisted by scanning the classified ads in newspapers serving the preferred area. Similarly, local realtors can often provide useful leads and assist greatly in putting the deal together at no cost to the buyer.

The evaluation of each opportunity on a comparative basis is crucial to the prospective buyer and his conclusions will determine what would be a fair price for the business. His analysis should include:

a) the reason the business is up for sale
b) its assets and liabilities
c) its history, location and potential
d) its profit record, operating ratios and projections.

He should not rush his investigations; time to get the needed information will pay off in reaching the decision whether to purchase and at what price. Some successful business owners report they considered alternatives for a year or more before deciding to go ahead.

An adverse trend apparent from the financial statements may reveal the true reason for selling; the prudent buyer should establish the reasons for such a trend and determine whether it is reversible or whether, for example, changes in the character of the neighbourhood are responsible.

One of the principal assets often involved in a change of ownership is the inventory. A physical count preferably by an independent appraiser should be taken to establish a fair price for it having regard to its saleability, condition and style and after making due allowance for any items that would have to be cleared out at a loss.

Similarly, the accounts receivable should be analysed for quality and aging. This simple analysis is an indication of the seller's credit and collection policies and of the level of operating capital required to support day-to-day operations. I.D.B. Pamphlet No. 5 called "Managing Your Current Assets" deals more fully with these two aspects.

If realty is involved in the prospective change of ownership, a professional appraisal of its value might be money well spent, since its condition and versatility should be reflected in the price offered. What alterations are needed and at what cost? Similarly the furniture, fixtures and equipment should be assessed.

The cautious buyer should determine there are no hidden liabilities such as unregistered liens against equipment, back taxes, pending law suits. An accountant's or lawyer's help at this stage would be wise. The agreement of purchase and sale should spell out that all claims not shown on the balance sheet used as the basis of sale are the responsibility of the seller.

The last two areas of evaluation, history, location and potential plus the financial data, should be made available by the seller (page 2) for the buyer's use. A wise buyer should prepare an operating projection for the first 12 months under his ownership, reflecting as closely as possible all changes he would propose to make in the running of the business. To assist him, he could refer to I.D.B. Pamphlet No. 4 - "Forecasting for an Existing Business".

The financing of the transaction must now be considered, assuming buyer and seller have reached agreement on price. The buyer will know how much cash he can safely invest in the business, leaving some in reserve in case of need, and how much assistance he can count on from his banker or other lender. Perhaps the seller is willing to finance part of the sale himself, that is, in effect to make a loan to the buyer, possibly secured by a mortgage on the business' fixed assets and repayable with interest over a term acceptable to both parties. Remember that whether the transaction is on an all-cash basis or partly financed should not affect the selling price.

CONCLUSIONS

The buyer should insist on full disclosure of all facets of the business he's interested in purchasing. He should not be stampeded into making a snap decision but should insist on adequate time to do the necessary research which would also involve seeking the advice of an accountant, a lawyer and possibly a real estate broker.

The formula discussed on pages 3 and 4 is not offered as a universal method of price evaluation but is a valid mathematical approach based on the financial standing of the business. Money is only one of the important factors; the buyer may be attracted to the location for personal reasons which could include a burning desire to be self-employed. Similarly, the seller's decision to dispose of the business may be very legitimate, such as poor health, the desire to retire or to relocate. Whatever the reason, the buyer should make it his business to find out.

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